THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

By email only: consultation@taskforceonsocialfactors.co.uk

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SPP response to DWP's consultation on Considering Social Factors in Pension Scheme Investments: Guide from the Taskforce on Social Factors (the "Guide")

We welcome the opportunity to respond to this consultation.

Executive Summary

We believe that the Guide will support trustees in better understanding and responding to social issues relevant to stewardship and investment decisions. Our comments focus on:

a) *Use of external resources*: In our experience, the majority of pension scheme trustees rely heavily on the external resources of asset managers and investment consultants when incorporating social factors within their investment decisions and stewardship policies. It is helpful that the Guide focuses on how trustees can use these resources more effectively when selecting managers and advisers, and holding them to account.

b) *Approach to disclosures*: We also welcome support for trustees and asset managers in meeting their existing disclosure obligations and commitments, such as implementation statements and the UK Stewardship Code. Trustees are continuing to adapt to the recent introduction of several governance and reporting standards, including the DWP's Statutory and Non-Statutory Guidance on Reporting on Stewardship, the Climate Change Governance and Reporting Regulations and the Pensions Regulator's forthcoming General Code. We therefore appreciate that the Guide has not recommended any further mandatory, standalone disclosures or standards which could incur costs disproportionate to their benefit to scheme members.

c) *Integrating social factors in trustee decisions*: Data and analysis on social issues are most useful when they support trustees in taking decisions which help achieve the wider goals of the scheme, such as endgame planning and risk management more generally. We have outlined below how we consider the recommendations and guidance provided by the Guide could be developed to better reflect the wider priorities and circumstances of UK pension schemes.

We hope this feedback will assist the Taskforce in achieving its intended policy aims of integrating the consideration of social factors within the pensions and investment industry.

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Detailed Response

1. **Do you agree the report will be helpful for pension scheme trustees to better understand social issues and the impetus to act on them?**

Overall, the Guide provides a useful repository of information and resources, which will help trustees better understand an area which may be unfamiliar to some of them. We anticipate that it will assist trustees in selecting asset managers and investment consultants, and holding them to account, in integrating social factors into investment and stewardship decisions.

It would, nevertheless, be helpful if the Taskforce could position some of these issues (and their recommendations) within the context of the wider pensions landscape and upcoming changes in pensions investment regulation, such as the new funding and investment regime for defined benefit ("**DB**") schemes, and current reporting requirements on stewardship (as outlined below). This would better equip trustees to incorporate social issues into wider decisions concerning their scheme, as in practice social issues are not considered in isolation.

2. **For scheme trustees, does this report adequately address and provide a way forward for your scheme circumstances?**

It would be helpful if the Taskforce could develop the Guide to address more closely how trustees can consider social issues based on the specific circumstances of their scheme.

In particular:

a) *Investment duties in practice*: Trustees are likely to find it helpful if the Guide distinguished between how investment duties apply to defined contribution ("**DC"**) and defined benefit ("**DB**") pension schemes – e.g. :
   (i) *In a DC context*: Although DC schemes may be able to offer self-select options with a greater focus on social impacts, it can be challenging to obtain sufficient evidence of member views to apply the Law Commission's two stage test where trustees are concerned about the limits of their primary investment objective when it comes to the application of certain social factors but a high proportion of members are in default funds.
   (ii) *In a DB context*: The scheme's investment strategy needs to take account of the scheme's funding levels and covenant risk (see below). Trustees may also find it helpful if the Guide reflected the changes being introduced by TPR's DB Funding Code and the upcoming funding and investment regime. In particular, it would also be worth addressing how social factors are relevant to schemes setting a long term asset strategy and adhering to principles on assessing risk on their journey to significant maturity.

b) *Covenant and funding*: We appreciate that the Taskforce's focus is on investment decisions. However, we believe that trustees would find it helpful to have guidance and recommendations on how these interact with covenant and funding issues, particularly while DB scheme trustees are grappling with the new investment and funding regime. For instance, in a DB scheme, trustees may need to give greater weight to assessing social factors in an investment context if they are exposed to certain risks from their employer covenant. Furthermore, social issues can pose specific risks to some covenants and trustees would welcome guidance on how they can ensure that they, and their advisers, can consider social risks in relation to covenants more effectively. Recommendation 1 could be broadened to address how covenant advisers approach social factors.

c) *Time horizons and endgame planning*: The relevance, materiality and management of social factors will depend upon the time horizon of both the scheme and the underlying investment funds.

Pensions regulation requires trustees to develop and disclose their policies concerning financially material considerations over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments. Trustee policies also need to cover (or explain the omission of) how the time horizon of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with their policies (Reg 2, 2005 Investment Regs).

The upcoming funding and investment regime for DB schemes requires trustees to develop a long term asset strategy by reference to when their scheme will reach significant maturity.

With this in mind, trustees are likely to find it helpful if the Taskforce could address:

(i) How trustees can identify, prioritise and manage social risks and opportunities and reflect these in their investment decisions by reference to the time horizons of their scheme (e.g. in the section on the Materiality and salience of social factors (p.7)). For instance, schemes may have greater scope to invest in long term asset classes which reflect social trends (e.g. social housing) if they are not targeting buy-out in the short term. We note that the Taskforce's three tier framework proposes that it would be good practice if DB schemes looking to buy-in/buy-out would assess the social (and other stewardship) credentials of the potential insurer's portfolio. Trustees may find it helpful if the Taskforce provided further guidance on how social factors can be considered in the context of the potential insurer's investment strategy and long-term ability to deliver the benefits being insured.

(ii) Where the time horizon of certain data sets may need to be improved to be useful to trustees in their decision making (Section 2: Social factor data, and Recommendations 20-24).

3. Do you see the proposed systematic materiality assessment framework for social factors as something you can practically implement in your portfolio?

We agree with the principle that trustees should identify and prioritise issues which are material within their portfolio. We recognise that the multifaceted nature of social issues can make this a particular challenge for trustees (in contrast to climate change data, for instance, which can be easier to quantify around a single dataset (relevant emissions) and metrics derived from this).

We believe that an effective materiality framework could help trustees better focus their dialogue with asset managers and investment consultants in relation to social issues. The framework set out in the Guide provides a helpful summary of the data sources available for assessing social factor risks and a useful breakdown of specific factors relevant at a corporate level. We believe trustees would also welcome a stronger steer within the guidance as to how schemes could scale this materiality assessment up to the particular risks that trustees should prioritise in assessments carried out at country and sector levels, as these levels are likely to be even more influential in strategic investment decision-making.

It is important for the Taskforce to be aware that in practice, few trustees are likely to have the resources, or expertise, to conduct the type of review envisaged by the materiality assessment framework themselves. In our experience, they would rely heavily on the capabilities of their investment consultants when evaluating the exposure of the investment portfolio to risk and this type of analysis would typically form part of a wider review into the risks facing the scheme. Similarly, meetings with asset managers would usually be wide ranging and trustees would need to address social risks alongside the scheme's other priorities. The framework might be adopted more widely if (i) it was presented as a tool for trustees to instruct, and assess the output of, their investment consultants and asset managers (rather than being implemented directly by trustees), and (ii) the Taskforce outlined how this type of analysis could be integrated within wider risk assessments carried out by trustees.

Schemes may also benefit from the Taskforce's views on how they can assess the materiality and salience of opportunities as well as risks. In certain cases the parameters will be the same (e.g. scope, scale and likelihood) but remediability will not be relevant, and other issues will be relevant to assessing the potential upside of certain investments (e.g. consumer demand).

4. Do you believe the three-level framework for addressing social factors in pension portfolios provides useful developmental guidance?

We believe that it is helpful that the Taskforce has acknowledged that the size, type and resource constraints of schemes will affect how they address social factors in their portfolios. Trustees will also need to take an approach which is proportionate to the benefits that such practices would have to scheme members and towards fulfilling the scheme's purpose.

Trustees with significant in-house capabilities may be equipped to participate in the initiatives proposed as leading practice. We anticipate that, initially, the Guide will be most useful for trustees, investment consultants and asset managers aiming for this standard, typically in larger pension schemes. However, in most cases, trustees are likely to find these standards to be very onerous. Without further consolidation, smaller schemes may lack the manpower, skills and experience needed to carry out good and leading practices. In order to extend the reach to smaller schemes, it is important that reporting and data improvements, influenced by this Guide, are made easily accessible by asset managers for all investors. Some trustees may also have concerns that adhering to the good or leading practices could lead to an overweighting of social factors in the scheme's stewardship priorities.

The framework is likely to be most useful to trustees where it identifies how:

a) trustees can improve how they use external resources, for instance when selecting managers and advisers, and holding them to account;
b) trustees can use delegation and oversight in order to carry out recommended activities; and
c) improvements can be made to existing practices (e.g. reporting under the UK Stewardship Code) and holistic analysis (which takes account of social factors alongside wider scheme priorities, including environmental and governance goals, based on overall materiality)

rather than through introducing additional, standalone reporting or initiatives for particular categories of factor.

5. Do you agree with the resulting recommendations for the pensions ecosystem?

Recommendations concerning trustees

In general, we support the Taskforce's current approach of proposing non-binding recommendations to develop market practice, rather than mandatory requirements for trustees, particularly in relation to reporting. We also welcome the focus on improving how trustees engage with their external advisers and asset managers.

In relation to the Taskforce's specific recommendations:

- *Covenant and Funding* (Recommendations 1): As noted above, this recommendation could address how trustees of DB schemes should take account of covenant advice and scheme funding levels when setting objectives related to social factors, and how they should engage with covenant advisers in relation to social factors. We would also welcome specific recommendations for covenant advisors on how they should ensure that they consider social factors where these raise specific risks in employer covenants.
- *Relative weightings* (Recommendations 1, 2 and 5): Does the Taskforce have any recommendations on how trustees can better understand how relative weightings can affect different social factors in an overall rating/strategy (see comments on Appendix 2, below)? This will be particularly relevant for trustees who need or wish to prioritise some particular social issues over others or set their investment beliefs around social factors – e.g. when considering social impact investment opportunities. We suggest that the "materiality matrix" case study from Railpen on (p.32) could be expanded into a framework through which this discussion could be conducted.
- *Scheme practices* (Recommendation 4): We recognise that scheme practices may be particularly pertinent to schemes aiming to adopt leading practice in relation to social factors and that this may reinforce their credibility (e.g. when undertaking stewardship activities on social issues). However, whilst it seems reasonable in principle that trustees should have policies covering social factors in the scheme's own operations (e.g. diversity, supply chains), we would question whether this falls within the Taskforce's remit, given that this Guide is primarily aimed at scheme investment practices. To the extent that the Taskforce does address these issues, we suggest the Taskforce should consider whether its recommendations remain consistent with the Pensions Regulator's guidance and forthcoming General Code.

Recommendations concerning asset managers

As noted above, the recommendations are most likely to be implemented effectively where they build on, and are integrated into, the existing practices of the pensions and investment industry. We believe that standards are more likely to assist trustees in making investment decisions where they encourage asset managers to integrate social factors into their holistic analysis and stewardship activity, rather than addressing them in isolation.

It would therefore be helpful if the Guide could set out explicitly how its recommendations interact with the current requirements under the UK Stewardship Code, and how the Code might need to be reformed to better reflect its recommendations.

Recommendations concerning legal advisers

We note that legal advisers can also assist trustees and asset managers in identifying, understanding and mitigating litigation risk (e.g. concerning disclosures, "sustainability-washing", scope of investee or parent company liability etc.) and how this can be assessed and managed at an asset, fund and investor level.

Legal input could also address whether qualitative analysis is sometimes helpful and justifiable when dealing with social factors (for example, because of the inherent difficulties of modelling in social factors analysis, as already highlighted in the guide and by other commentators).

We would welcome a recommendation from the Taskforce that both legal advisers and investment consultants work in collaborative dialogue with one another so that advice is always given in its proper legal and investment strategic contexts. There could be an equivalent recommendation for trustees to use and encourage all their advisers in this direction, especially in the early stages of integrating social factors.

Recommendations concerning businesses and employers

We agree with the Taskforce's view that investors rely heavily on the data provided by businesses to assess social risks and opportunities. This is key to understanding not only the implications of social issues for investment decisions, but also for covenant analysis. It is therefore not unrealistic to take the view that, without adequate and consistent disclosure at the level of the ultimate investee entity, the investment governance frameworks of institutional investors, and the practices of those who provide advisory and asset management services to them, will only be capable of taking progress so far. For this reason, we suggest that the Taskforce strengthens its recommendations for businesses and employers to gather and report on the data required for investors to properly understand their approach to managing social factors.

6. Do you find the information in appendices practical and informative?

Challenging weightings given to social factors

As noted above, the questions in Appendix 2 could explicitly address how investment consultants/ asset managers can help trustees understand how relative weightings can affect different social factors in an overall rating/strategy.

The Guide rightly acknowledges (e.g. in its materiality assessment framework) that multiple social factors will often be in play within the same strategy, or within the same investee. However, trustees are unlikely to have the time or resources to disentangle the relative weight given to different social factors within an overall strategy or fund choice.

There is therefore a potential risk of "social washing" (e.g. that something might be accepted on the basis of a high aggregate "S" score but in substance that score is attributable to the asset or fund's performance on (for example) health and safety despite relative weakness on other social aspects, such as local minimum wage and the impact this has on communities, in circumstances where these latter issues may be more closely aligned to the scheme's social factor beliefs and priorities). It would be helpful if Appendix 2 could address how trustees can challenge information constructively and critically, and press their advisers in relation to this risk.

Voting policies

Appendix 2 (p.22) also includes guidance on "How to assess whether trustees might benefit from setting their own voting policy". This could cause some confusion as trustees are already required to have a policy on the exercise of rights (including voting rights) within the SIP under investment regulations. The Guide could instead refer to how trustees can "develop" or "improve" their voting policies to better incorporate priorities focused around social factors.

Stewardship

Trustees may also find it helpful if the Guide made a clearer distinction between the questions trustees could raise concerning the different options for stewardship available in different investment contexts – e.g.

- fixed income vs. equity – e.g. how trustees/ asset managers can address the lack of automatic voting rights by adopting other engagement strategies;
- primary vs. secondary transactions – e.g. on the scope for negotiating participation terms; and
- listed vs. private – e.g. impact of disclosure obligations on available data, scope for divestment/ investable limits in illiquid markets.

7. Is there anything else that you would like to see covered?

Public disclosures and voting policies

Trustees are likely to find the Guide particularly useful where it sets out how they can integrate social issues into fulfilling their existing obligations – particularly where those requirements have been introduced recently and market practice is still evolving.

It's therefore helpful that the Guide refers to the DWP's Statutory and Non-Statutory Guidance on Reporting on Stewardship and Other Topics through the Statement of Investment Principles and the Implementation Statement. Trustees may find it useful if the Guide reminded them of some of the changes this introduced for implementation statements prepared in respect of any scheme year ending on or after 1 October 2022 – e.g.

- encouraging trustees to explain how their stewardship activities are in scheme members' and beneficiaries' best interests, and
- mandatory requirements to provide descriptions of voting behaviour by, or on behalf of, trustees (including the most significant votes cast by, or on behalf of, the trustees).

Fiduciary and other duties of pension trustees

This section helpfully refers to the *Fiduciary Duty in the 21st Century* report, published in 2015 by the PRI, UNEP FI, UNEP Inquiry, and UN Global Compact. Trustees may also find it useful if the Guide also referred them to the PRI's 2021 Legal Framework for Impact or 2023 Legal framework for impact (UK): integrating sustainability investment goals across the investment industry, which were more focused on the current legal position relating to pension scheme investment in the UK. These reports provide more detail on the scope (and limits) of trustee powers and duties in the context of impact investing – so we would recommend mentioning them on the section on "Positive and negative social impacts" (p.7), alongside the 2020 paper from the Impact Investing Institute (which is already mentioned).

Paragraph 3 of this section focuses on the scope for ESG factors to become financial factors. In practice, it is often unhelpful to apply a binary test to assessing whether an issue is a financially material factor or a non-financial factor. It may be both, and in many cases financial and non-financial interests can and do align. It will usually be more consistent with caselaw (and still consistent with the Law Commission's reports) for trustees to focus on their obligation to use the investment power prudently and for its proper purpose.

We would suggest adjusting the emphasis in the final paragraph in this section, so it's clear that trustees can consider the transition to net zero as part of considering and balancing investment risks.

Trustees are also likely to find it helpful if the Guide outlined the limits of the scope for trustees to invest for impact (in the section headed "Positive and negative social impacts"). Currently, there is a widely held view that, whilst trustees can treat social impact as a corollary outcome of a financially-driven investment approach, they cannot invest for the primary purpose of ensuring that the scheme has a positive social impact (as addressed in greater detail in the 2020 paper from the Impact Investing Institute, already cited in the Guide, and the further reports listed above).

Addressing social factors in pension portfolios

This section could note that trustees could better address social factors through improving their governance processes. This is consistent with the current recommendations (obtaining appropriate information and advice, considering that information, asking questions, having sufficient expertise and understanding), but would reinforce that these practices are consistent with trustees' current fiduciary duties and regulatory guidance.

Response ends.-

Yours faithfully,

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